

trust the income of which is to be distributed to the beneficiaries currently, each beneficiary is entitled to exemption as if he owned directly a proportionate part of the Treasury bonds held in trust. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trust, as the owner of the bonds held in trust, is entitled to the exemption on account of such ownership. In general, see sections 652(b) and 662(b) and the regulations thereunder.

(b) As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership. For rules relating to partially tax-exempt interest see section 702(a)(7) and the regulations thereunder.

§ 1.103-6 Interest upon United States obligations in the case of non-resident aliens and foreign corporations, not engaged in business in the United States.

By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (31 U.S.C. 750), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (31 U.S.C. 750), the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued before March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in paragraph (b) of § 1.103-4.

§ 1.103-7 Industrial development bonds.

(a) *In general.* Under section 103(c)(1) and this section, an industrial development bond issued after April 30, 1968, shall be treated as an obligation not

described in section 103(a)(1) and § 1.103-1. Accordingly, interest paid on such a bond is includable in gross income unless the bond was issued by a State, or local governmental unit to finance certain exempt facilities (see section 103(c)(4) and § 1.103-8), to finance an industrial park (see section 103(c)(5) and § 1.103-9), or as part of an exempt small issue (see section 103(c)(6) and § 1.103-10). For applicable rules when an industrial development bond is held by a substantial user (or a person related to a substantial user) of such an exempt facility, or an industrial park, or a facility financed with the proceeds of such an exempt small issue, see section 103(c)(7) and § 1.103-11. See also § 1.103-12 for the transitional provisions concerning the interest paid on certain industrial development bonds issued before January 1, 1969, and certain other industrial development bonds. Even if section 103(c) does not prevent a bond from being treated as an obligation described in section 103(a)(1) and § 1.103-1, such bond shall nevertheless be treated as an obligation which is not described in section 103(a)(1) and § 1.103-1 if under section 103(d) it is an arbitrage bond. For purposes of section 103(c), the term "issue" includes a single obligation such as a single note issued in connection with a bank loan as well as a series of notes or bonds.

(b) *Industrial development bonds—(1) Definition.* For purposes of this section, the term "industrial development bond" means any obligation—

(i) Which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (as defined in subparagraph (2) of this paragraph), and

(ii) The payment of the principal or interest on which, under the terms of such obligation or any underlying arrangement (as described in subparagraph (4) of this paragraph), is in whole or in major part (i.e., major portion)—

(a) Secured by any interest in property used or to be used in a trade or business,

(b) Secured by any interest in payments in respect of property used or to be used in a trade or business, or

(c) To be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

See subparagraphs (3) and (4) of this paragraph for the trade or business test and the security interest test respectively. See § 1.103-8(a)(6) to determine the amount of proceeds of an issue for which the amount payable during each annual period over the term of the issue is less than the amount of interest accruing thereon in such period, e.g., in the case of an issue sold by the issuer for less than its face amount.

(2) *Exempt person.* The term “exempt person” means a governmental unit as defined in this subparagraph, or an organization which is described in section 501(c)(3) and this subparagraph and is exempt from taxation under section 501(a). For purposes of this subparagraph, the term “governmental unit” means a State or local governmental unit (as defined in § 1.103-1). For purposes of this subparagraph, the term “governmental unit” also includes the United States of America (or an agency or instrumentality of the United States of America), but only in the case of obligations (i) issued on or before August 3, 1972, or (ii) issued after August 3, 1972, with respect to which a bond resolution or any other official action was taken and in reliance on such action either (a) construction of such facility to be financed with such obligations commenced or (b) a binding contract was entered into, or an irrevocable bid was submitted, prior to August 3, 1972, or (iii) issued after August 3, 1972, with respect to a program approved by Congress prior to such date but only if (a) a portion of such program has been financed by obligations issued prior to such date, to which section 103(a) applied pursuant to a ruling issued by the Commissioner or his delegate prior to such date and (b) construction of one or more facilities comprising a part of such program commenced prior to such date. For purposes of this subparagraph, a tax-exempt organization is an exempt person only with respect to a trade or business it carries on which is not an unrelated trade or business. Whether a particular trade or business carried on by a tax-exempt organization is an unrelated

trade or business is determined by applying the rules of section 513(a) (relating to general rule for unrelated trade or business) and the regulations thereunder to the tax-exempt organization without regard to whether the organization is an organization subject to the tax imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc., organizations).

(3) *Trade or business test.* (i) The trade or business test relates to the use of the proceeds of a bond issue. The test is met if all or a major portion of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons, and the debt obligations comprising the bond issue satisfy the trade or business test. If, however, less than a major portion of the proceeds of an issue is to be loaned to nonexempt persons or is to be used to acquire or construct facilities which will be used in a trade or business carried on by a nonexempt person, the debt obligations will not be industrial development bonds. Also, when publicly-owned facilities which are intended for general public use, such as toll roads or bridges, are constructed with the proceeds of a bond issue and used by nonexempt persons in their trades or businesses on the same basis as other members of the public, such use does not constitute a use in the trade or business of a nonexempt person for purposes of the trade or business test.

(ii) In determining whether a debt obligation meets the trade or business test, the indirect, as well as the direct, use of the proceeds is to be taken into account. For example, the debt obligations comprising a bond issue do not fail to satisfy the trade or business test

merely because the State or local governmental unit uses the proceeds to engage in a series of financing transactions for property to be used by private business users in trades or businesses carried on by them. Similarly, if such proceeds are to be used to construct facilities to be leased or sold to any nonexempt person for use in a trade or business it carries on, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. If such proceeds are to be used to construct facilities to be leased or sold to an exempt person who will, in turn, lease or sell the facilities to a nonexempt person for use in a trade or business, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test. In addition, proceeds will be treated as being used in the trade or business of a nonexempt person in situations involving other arrangements, whether in a single transaction or in a series of transactions, whereby a nonexempt person uses property acquired with the proceeds of a bond issue in its trade or business.

(iii) The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner. In the case of the direct or indirect use of the proceeds of an issue of obligations or the direct or indirect use of a facility constructed, reconstructed, or acquired with such proceeds, the use by all nonexempt persons in their trades or businesses must be aggregated to determine whether the trade or business test is satisfied. If more than 25 percent of the proceeds of a bond issue is used in the trades or businesses of nonexempt persons, the trade or business test is satisfied. For special rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(4) *Security interest test.* The security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the

payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement to provide security for, or the source of, the payment of the principal or interest on an obligation may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance of the bonds. The property which is the security for, or the source of, the payment of either the principal or interest on a debt obligation need not be property acquired with bond proceeds. The security interest test is satisfied if, for example, a debt obligation is secured by unimproved land or investment securities used, directly or indirectly, in any trade or business carried on by any private business user. A pledge of the full faith and credit of a State or local governmental unit will not prevent a debt obligation from otherwise satisfying the security interest test. For example, if the payment of either the principal or interest on a bond issue is secured by both a pledge of the full faith and credit of a State or local governmental unit and any interest in property used or to be used in a trade or business, the bond issue satisfies the security interest test. For rules with respect to the acquisition of the output of facilities see subparagraph (5) of this paragraph.

(5) *Trade or business test and security interest test with respect to certain output contracts.* (i) The use by one or more nonexempt persons of a major portion of the subparagraph (5) output of facilities such as electric energy, gas, or water facilities constructed, reconstructed, or acquired with the proceeds of an issue satisfies the trade or business test and the security interest test if such use has the effect of transferring to nonexempt persons the benefits of ownership of such facilities, and the burdens of paying the debt service on governmental obligations used directly or indirectly to finance such facilities, so as to constitute the indirect use by them of a major portion of such proceeds. Such benefits and burdens are transferred and a major portion of the proceeds of an issue is used indirectly by the users of the subparagraph (5) output of such a facility which is

owned and operated by an exempt person where—

(a)(1) One nonexempt person agrees pursuant to a contract to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output (within the meaning of subdivision (ii) of this subparagraph) of such a facility (whether or not conditional upon the production of such output) or (2) two or more nonexempt persons, each of which pays annually a guaranteed minimum payment exceeding 3 percent of the average annual debt service with respect to the obligations in question, agree, pursuant to contracts, to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output of such a facility (whether or not conditioned upon the production of such output), and

(b) Payment made or to be made with respect to such contract or contracts by such nonexempt person or persons exceeds a major part (more than 25 percent) of the total debt service with respect to such issue of obligations.

(ii) For purposes of this subparagraph—

(a) Where a contract described in subdivision (i) of this subparagraph may be extended by the issuer of obligations described therein, the term of the contract shall be considered to include the period for which such contract may be so extended.

(b) The subparagraph (5) output of a facility shall be determined by multiplying the number of units produced or to be produced by the facility in 1 year by the number of years in the contract term of the issue of obligations issued to provide such facility. The number of units produced or to be produced by a facility in 1 year shall be determined by reference to its nameplate capacity (or where there is no nameplate capacity, its maximum capacity) without any reduction for reserves or other unutilized capacity. The contract term of an issue begins on the date the output of a facility is first taken, pursuant to a take or a take or pay contract, by a nonexempt person and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before

the date of issue of a prior issue of governmental obligations issued to provide a facility, the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, then the contract term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue with respect to such facility (determined without regard to any optional redemption dates). Where it appears that the term of an issue (or the terms of two or more issues) is extended for purposes of extending the contract term of an issue and thereby increasing the subparagraph (5) output of the facility provided by such issue, the subparagraph (5) output of such facility shall be determined by the Commissioner without regard to the provisions of this subdivision (b).

(c) The total debt service with respect to an issue of obligations shall be the total dollar amount (excluding any penalties) payable with respect to such issue over its entire term. The entire term of an issue begins on its date of issue and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, the entire term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue (determined without regard to any optional redemption dates).

(d) Two or more nonexempt persons who are related persons (within the meaning of section 103(c)(6)(C)) shall be treated as one nonexempt person.

(c) *Examples.* The application of the rules contained in section 103(c) (2) and (3) and paragraph (b) of this section are illustrated by the following examples:

Example (1). State A and corporation X enter into an arrangement under which A is to provide a factory which X will lease for 20 years. The arrangement provides (1) that A

will issue \$10 million of bonds, (2) that the proceeds of the bond issue will be used to purchase land and to construct and equip a factory in accordance with X's specifications, (3) that X will rent the facility (land, factory, and equipment) for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself will be the security for the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used (by purchasing land and constructing and equipping the factory) in a trade or business by a nonexempt person, and (2) the payment of the principal and interest on which is secured by the facility and payments to be made with respect thereto.

Example (2). The facts are the same as in example (1) except that (1) X will purchase the facility, and (2) annual payments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds will be made by X. The bonds are industrial development bonds for the reasons set forth in example (1).

Example (3). State B and corporation X enter into an arrangement under which B is to loan \$10 million to X. The arrangement provides (1) that B will issue \$10 million of bonds, (2) that the proceeds of the bond issue will be loaned to X to provide additional working capital and to finance the acquisition of certain new machinery, (3) that X will repay the loan in annual installments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that the payments on the loan and the machinery will be the security for only the payment of the principal on the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used in a trade or business by a nonexempt person, and (2) the payment of the principal on which is secured by payments to be made in respect of property to be used in a trade or business. The result would be the same if only the payment of the interest on the bonds were secured by payments on the loan and machinery.

Example (4). The facts are the same as in example (1), (2), or (3) except that the annual payments required to be made by corporation X exceed the amount necessary to amortize the principal and pay the interest on the outstanding bonds. The bonds are industrial development bonds for the reasons set forth in such examples. The fact that corporation X is required to pay an amount in excess of the amount necessary to pay the principal and interest on the bonds does not affect their status as industrial development bonds. Similarly, if the annual payments required to be made by corporation X were sufficient

to pay only a major portion of either the principal or the interest on the outstanding bonds, the bonds would be industrial development bonds for the reasons set forth in such examples.

Example (5). The facts are the same as in example (1), (2), (3), or (4) except that the issuer is a political subdivision which has taxing power and the bonds are general obligation bonds. Since both the trade or business and the security interest tests are met, the bonds are industrial development bonds notwithstanding the fact that they constitute an unconditional obligation of the issuer payable from its general revenues.

Example (6). (a) State C issues its general obligation bonds to purchase land and construct a hotel for use by the general public (i.e., tourists, visitors, travelers on business, etc.). The bond indenture provides (1) that C will own and operate the project for the period required to redeem the bonds, and (2) that the project itself and the revenues derived therefrom are the security for the bonds. The bonds are not industrial development bonds since (1) the proceeds are to be used by an exempt person in a trade or business carried on by such person, and (2) a major portion of such proceeds is not to be used, directly or indirectly, in a trade or business carried on by a nonexempt person. Use of the hotel by hotel guests who are travelling in connection with trades or businesses of nonexempt persons is not an indirect use of the hotel by such nonexempt persons for purposes of section 103(c).

(b) The facts are the same as in paragraph (a) of this example except that corporation Y enters into a long-term agreement with C that Y will rent more than one-fourth of the rooms on an annual basis for a period approximately equal to one half of the term of the bonds. The bonds are industrial development bonds because (1) a major portion of the proceeds used to construct the hotel is to be used in the trade or business of corporation Y (a nonexempt person) and (2) a major portion of the principal and interest on such issue will be derived from payments in respect of the property used in the trade or business of Y.

Example (7). (a) State D and corporation Y enter into an agreement under which Y will lease for 20 years three floors of a 12-story office building to be constructed by D on land which it will acquire. D will occupy the grade floor and the remaining eight floors of the building. The portion of the costs of acquiring the land and constructing the building which are allocated to the space to be leased by Y is not in excess of 25 percent of the total costs of acquiring the land and constructing the building. Such costs, whether attributable to the acquisition of land or the construction of the building, were allocated to leased space in the same proportion that the reasonable rental value of such leased

space bears to the reasonable rental value of the entire building. From the facts and circumstances presented, it is determined that such allocation was reasonable. The arrangement between D and Y provides that D will issue \$10 million of bonds, that the proceeds of the bond issue will be used to purchase land and construct an office building, that Y will lease the designated floor space for 20 years at its reasonable rental value, and that such rental payments and the building itself shall be security for the bonds. The bonds are not industrial development bonds since a major portion of the proceeds is not to be used, directly or indirectly, in the trade or business of a nonexempt person.

(b) The facts are the same as in paragraph (a) of this example except that corporation Y will lease four floors, and the costs allocated to these floors are in excess of 25 percent of D's investment in the land and building. The bonds are industrial development bonds because (1) a major portion of the building is to be used in the trade or business of a nonexempt person, and (2) a major portion of the principal and interest on such issue is secured by the rental payments on the building.

Example (8). The facts are the same as in paragraph (b) of example (7) except that, instead of leasing any space to corporation Y, State D will lease the four floors to numerous unrelated private business users to be used in their trades or businesses. No lease will have a term exceeding 2 years. A major portion of the principal and interest will be paid from the revenues that D will derive from such leases. The fact that the activities of D, an exempt person, may amount to a trade or business of leasing property is not material, and the bonds are industrial development bonds for the reasons set forth in paragraph (b) of example (7). The result would be the same in the case of long-term leases.

Example (9). State E issues its obligations to finance the construction of dormitories for educational institution Z which is an organization described in section 501(c)(3) and exempt from tax under section 501(a). The dormitories are to be owned and operated by Z and their operation does not constitute an unrelated trade or business. The bonds are not industrial development bonds since the proceeds are to be used by an exempt person in a trade or business carried on by such person which is not an unrelated trade or business, as determined by applying section 513(a) to Z.

Example (10). State F issues its obligations to finance the construction of a toll road and the cost of erecting related facilities such as gasoline service stations and restaurants. Such related facilities represent less than 25 percent of the total cost of the project and are to be leased or sold to nonexempt persons. The toll road is to be owned and oper-

ated by F. The revenues from the toll road and from the rental of related facilities are the security for the bonds. The bonds are not industrial development bonds since a major portion of the proceeds is not to be used, directly or indirectly, in the trades or businesses of nonexempt persons. The fact that vehicles owned by nonexempt persons engaged in their trades or businesses may use the road in common with, or as a part of, the general public is not material.

Example (11). City G issues its obligations to finance the construction of a municipal auditorium which it will own and operate. The use of the auditorium will be open to anyone who wishes to use it for a short period of time on a rate-scale basis. The rights of such a user are only those of a transient occupant rather than the full legal possessory interests of a lessee. It is anticipated that the auditorium will be used by schools, church groups, and fraternities, and numerous commercial organizations. The revenues from the rentals of the auditorium and the auditorium building itself will be the security for the bonds. The bonds are not industrial development bonds because such use is not a use in the trade or business of a nonexempt person.

Example (12). The facts are the same as in example (11) except that one nonexempt person will have a 20-year rental agreement providing for exclusive use of the entire auditorium for more than 3 months of each year at a rental comparable to that charged short-term users. The bonds are industrial development bonds since such use is a use in the trade or business of a nonexempt person and, therefore, a major portion of the proceeds of the issue will be used in the trade or business of a nonexempt person and a major portion of the principal or interest on such issue will be secured by a facility used in such trade or business and by payments with respect to such facility.

Example (13). In order to construct an electric generating facility of a size sufficient to take advantage of the economies of scale: (1) City H will issue \$50 million of its 25-year bonds and Z (a privately owned electric utility) will use \$100 million of its funds for construction of a facility they will jointly own as tenants in common. (2) Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. (3) H's bonds will be secured by H's ownership in the facility and by revenues to be derived from the sale of H's share of the annual output of the facility. (4) Because H will need only 50 percent of its share of the annual output of the facility, it agrees to sell to Z 25 percent of its share of such annual output for a period of 20 years pursuant to a contract under which Z agrees to take

or pay for such power in all events. The facility will begin operation, and Z will begin to receive power, 4 years after the City H obligations are issued. The contract term of the issue will, therefore, be 21 years. (5) H also agrees to sell the remaining 25 percent of its share of the annual output to numerous other private utilities under a prevailing rate schedule including demand charges. (6) No contracts will be executed obligating any person other than Z to purchase any specified amount of the power for any specified period of time and no one such person (other than Z) will pay a demand charge or other minimum payment under conditions which, under paragraph (b)(5) of this section, result in a transfer of the benefits of ownership and the burdens of paying the debt service on obligations used directly or indirectly to provide such facilities. The bonds are not industrial development bonds because H's one-third interest in the facility (financed with bond proceeds) shall be treated as a separate property interest and, although 25 percent of H's interest in the annual output of the facility will be used directly or indirectly in the trade or business of Z, a nonexempt person, under the rule of paragraph (b)(5) of this section, such portion constitutes less than a major portion of the subparagraph (5) output of the facility. If more than 25 percent of the subparagraph (5) output of the facility were to be sold to Z pursuant to the take or pay contract, the bonds would be industrial development bonds since they would be secured by H's ownership in the facility and revenues therefrom, and under the rules of paragraph (b)(5) of this section a major portion of the proceeds of the bond issue would be used in the trade or business of Z, a nonexempt person.

Example (14). J, a political subdivision of a State, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. More than 25 percent of the proceeds of each issue will be used for the rehabilitation and construction of buildings which will be leased or sold to nonexempt persons for use in their trades or businesses. There is no limitation either on the number of issues or the aggregate amount of bonds which may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal and interest on each issue of bonds. Further, it is apparent that J requires the revenues from the lease or sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds in question. The bonds are in-

dustrial development bonds because a major portion of the proceeds will be used in the trades or businesses of nonexempt persons and, pursuant to an underlying arrangement, payment of the principal and interest is, in major part, to be derived from payments in respect of property or borrowed money used in the trades or businesses of nonexempt persons.

Example (15). Power Authority K, a political subdivision created by the legislature in State X to own and operate certain power generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in 1970, whereby such four systems are required to take or pay for specified portions of the total power output until the year 2000. Currently, existing facilities supply all of the present needs of the four utility systems but their future power requirements are expected to increase substantially. K issues 20-year general obligation bonds to construct a large nuclear generating facility. A fifth private utility system contracts with K to take or pay for 30 percent of the subparagraph (5) output of the new facility. The balance of the power output of the new facility will be available for sale as required, but initially it is not anticipated there will be any need for such power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 25 percent of the principal or interest on the bonds. The balance, which will exceed 25 percent of the principal or interest on such bonds, will be paid from revenues from the contracts with the four systems from sale of power produced by the old facilities. The bonds will be industrial development bonds because a major portion of the proceeds will be used in the trade or business of a nonexempt person, and payment of the principal and interest, pursuant to an underlying arrangement, will be derived in major part from payments in respect of property used in the trades or businesses of nonexempt persons.

(d) *Certain refunding issues—(1) General rule.* In the case of an issue of obligations issued to refund the outstanding face amount of an issue of obligations, the proceeds of the refunding issue will be considered to be used for the purpose for which the proceeds of the issue to be refunded were used. The rules of this subparagraph shall apply regardless of the date of issuance of the issue to be refunded and shall apply to refunding issues to be issued to refund prior refunding issues.

(2) *Obligations issued prior to effective date.* In the case of an issue of obligations issued to refund the outstanding face amount of an issue of obligations

issued on or before April 30, 1968 (or before January 1, 1969, if the transitional rules of § 1.103-12 are applicable) which would have been industrial development bonds within the meaning of section 103(c)(2) had they been issued after such date, the refunding issue shall not be considered to be an issue of industrial development bonds if it does not make funds available for any purpose other than the debt service on the obligations. For rules as to arbitrage bonds, see section 103(d).

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). In 1969, State A issued \$20 million of 20-year revenue bonds the proceeds of which were used to construct a sports facility which qualifies as an exempt facility described in section 103(c)(4)(B) and paragraph (c) of § 1.103-8. The sports facility will be owned and operated by X, a nonexempt person, for the use of the general public. In 1975, A issues \$15 million of revenue bonds in order to refund the outstanding face amount of the 1969 issue. Since the proceeds of the 1969 issue were used for an exempt facility, the proceeds of the 1975 refunding issue will be considered to be used for the same purposes and section 103(c)(1) shall not apply to the 1975 refunding issue. The result would have been the same if the original issue had been issued in 1965. For rules as to a refunding obligation held by substantial users of facilities constructed with the proceeds of the issue refunded, see section 103(c)(7) and § 1.103-11.

Example (2). In 1967, prior to the effective date of section 103(c), city B issued \$10 million of revenue bonds the proceeds of which were used to construct a manufacturing facility for corporation Y, a nonexempt person. Lease payments by Y were security for the bonds. In 1975, B issues \$7 million of revenue bonds in order to retire the outstanding face amount of the 1967 issue. The interest rate of the 1975 issue is one and one-half percentage points lower than the interest rate on the 1967 issue. Both issues sold at par. All of the terms of the 1975 issue are the same as the terms of the 1967 issue with the exception of the interest rate. The 1975 refunding issue will not be considered to be an issue of industrial development bonds since the refunding issue will not make funds available for any purpose other than the debt service on the outstanding obligations.

Example (3). The facts are the same as in example (2) except that the interest rate on the refunding issue is the same as the interest rate on the issue to be refunded. Assume further that city B issued the 1975 refunding issue in order to extend the term of the obli-

gations issued in 1967 as the result of its inability to pay such obligations due to insufficient revenues. The results will be the same as in example (2) for the reasons stated therein.

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§ 1.103-8 Interest on bonds to finance certain exempt facilities.

(a) *In general*—(1) *General rule.* (i) Under section 103(b)(4), interest paid on an issue of obligations issued by a State or local governmental unit (as defined in § 1.103-1) is not includable in gross income if substantially all of the proceeds of such issue is to be used to provide one or more of the exempt facilities listed in subparagraphs (A) through (J) of section 103(b)(4) and in this section. However, interest on an obligation of such issue is includable in gross income if the obligation is held by a substantial user or a related person (as described in section 103(b)(13) and § 1.103-11). If substantially all of the proceeds of a bond issue is to be used to provide such exempt facilities, the debt obligations are treated as obligations described in section 103(a)(1) and § 1.103-1 even though such obligations are industrial development bonds as defined in section 103(b)(2) and § 1.103-7. Substantially all of the proceeds of an issue of governmental obligations are used to provide an exempt facility if 90 percent or more of such proceeds are so used. For purposes of this “substantially all” test, two rules apply. First, proceeds are reduced by amounts properly allocable on a pro rata basis between providing the exempt facility and other uses of the proceeds. Second, amounts used to provide an exempt facility include amounts paid or incurred which are chargeable to the facility’s capital account or would be so chargeable either with a proper election by a taxpayer (for example, under section 266) or but for a proper election by a taxpayer to deduct such amounts. In the event the amount payable with respect to an issue during each annual period over its term is less than the amount of interest accruing thereon in such period, e.g., in the case of an issue sold by the issuer for less than its face amount, see paragraph